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N.C. Utilities Commission

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August 19, 2013

Gail L. Mount
Chief Clerk
NC Utilities Commission
4325 Mail Service Center
Raleigh, NC 27699-4325

Re: Docket No. E-7, Sub 1026 (Duke rate case)

Dear Ms. Mount:

Please find for filing the original and 30 copies of the NC WARN'S BRIEF. We are also filing a copy in electronic format to briefs@ncuc.net.

Thank you for your attention to this matter.

Sincerely,

John D. Runkle

John D. Runkle
Counsel for NC WARN

cc. Service List – via email

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STATE OF NORTH CAROLINA
UTILITIES COMMISSION
RALEIGH

DOCKET NO. E-7, SUB 1026

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

In the Matter of Application of Duke Energy Carolinas, LLC, for an Adjustment of Rates and Charges Applicable to Electric Utility Service in North Carolina	)))))	NC WARN'S BRIEF

NOW COMES the North Carolina Waste Awareness and Reduction Network, ("NC WARN"), by and through the undersigned attorney, with a brief proposing findings on issues presented at the public and evidentiary hearings on this matter. This brief relies heavily on the expert testimony provided by William B. Marcus on behalf of NC WARN, as further supported by testimony of many members of the public who overwhelmingly opposed the proposed rate increase.

In this brief, NC WARN is proposing findings below on:

1. Duke Energy does not provide affordable and economic service to its customers and therefore is not complying with state policy.

2. The Agreement and Stipulation of Settlement (the "settlement agreement") between Duke Energy and the Public Staff does not resolve major issues in the case, including cost allocation methodology and the return on equity ("ROE").

3. Duke Energy's preferred cost allocation method, the summer coincident peak, is discriminatory between customer classes as it unfairly pushes

the costs of expensive baseload power plants on residential and small business customers.

4. Duke Energy unfairly overcharges ratepayers through improper accounting practices, and demonstrable and repeated errors.

5. Costs for Duke Energy's transmission and distribution system and account representatives are improperly allocated to residential customers.

Supported by the proposed findings below, NC WARN therefore urges the Commission to deny Duke Energy's application for a rate hike, or in the alternative, substantially modify the settlement agreement between Duke Energy and the Public Staff to result in fair and reasonable rates.

SCOPE OF REVIEW

Duke Energy is a regulated utility operating as a monopoly within its service area. This sets up a conflict with North Carolina's constitutional provision that monopolies are prohibited in this state. "Perpetuities and monopolies are contrary to the genius of a free state and shall not be allowed." NC Constitutions, Article I, Section 34. Case law bears this out, stating that "the distinctive characteristics of a monopoly are (1) control of so large a portion of the market of a certain commodity that (2) competition is stifled, (3) freedom of commerce is restricted and (4) the monopolist controls prices." *American Motors Sales Corp. v. Peters*, 311 NC 311, 317 S.E.2d 351(1984). Duke Energy is clearly a monopoly under the first three characteristics of this definition, and in this rate case Duke Energy has attempted to control prices, i.e., the rates it collects from

its customers, contrary to state policy.

Duke Energy is only allowed to operate as a monopoly because it is regulated by the Commission as a public utility. If Duke Energy does not operate in accordance with state policy, or if the Commission does not compel it to do so, then Duke Energy cannot operate in North Carolina. The Commission has the authority to "compel [its] operation in accordance with policy of the state as declared in statute." *State ex rel. Utils. Comm'n v. Public Staff - NC Utils. Comm'n*, 123 NC App. 623, 473 S.E.2d 661 (1996).

The general public policy of the State as declared in G.S. 62-2(a)(3) is "to promote adequate, reliable and **economical** utility service to all of the citizens and residents of the State." (emphasis added). In the context of rate proceedings, this policy is explained in G.S. 62-2(a)(4):

> To provide just and reasonable rates and charges for public utility services without unjust discrimination, undue preferences or advantages, or unfair or destructive competitive practices and consistent with long term management and conservation of energy resources by avoiding wasteful, uneconomic and inefficient uses of energy.

To carry out these policies, the "Commission shall make, fix, establish or allow just and reasonable rates for all public utilities subject to its jurisdiction." G.S. 62-130. This authority includes both the Commission's duty to the public as well as to the utility. *State ex rel. N.C. Utils. Comm'n v. Westco Tel. Co.*, 266 N.C. 450, 146 S.E.2d 487 (1966). However, "the primary purpose of the Public Utilities Act is not to guarantee to stockholders of public utility constant growth in value of and in dividend yield from their investment, but is to assure public of adequate service at reasonable charge." *State ex rel. Utils. Comm'n v. Mountain*

Elec. Coop., 423 S.E.2d 516, 108 N.C. App. 283, affirmed 435 S.E.2d 71, 334 N.C. 681 (1992).

The burden of proof on all components making up the proposed rates lies with the utility. In the context of this rate case, the duty of the Commission is to review the rates as proposed by Duke Energy and only authorize rates the Commission determines to be "just and reasonable." In interpreting the Commission's mandate, case law states that the "Commission has no power to authorize rates that result in unreasonable and unjust discrimination." *State ex rel. N.C. Utils. Comm'n v. N.C. Textile Mfrs. Ass'n, Inc.*, 313 N.C. 215, 328 S.E.2d 264 (1985). Factors in determining whether a proposed rate results in unreasonable discrimination include "quantity of use, time of use, manner of service, costs of rendering the two services, competitive conditions, consumption characteristics of several classes and value of service to each class." *N.C. Textile Mfrs, supra.* Unreasonable and unjust discrimination can occur between classes when one class unduly benefits from a rate or utility practice, or within a class if certain ratepayers benefit at the expense of others.

In rate cases, such as the one *sub judice*, the Commission's findings of fact on the return on equity ("ROE") are of utmost importance because of the ROE's overall impact on the rates.

> ROE is the return that a utility is allowed to earn on its capital investment, which is realized through rates collected from its customers. The ROE affects profits to the Utility's shareholders and has a significant impact on what customers ultimately pay the utility. The higher the ROE, the higher the resulting rates that customers will pay to the utility.

State ex rel. Utils. Comm'n v. Carolina Util. Customers Ass'n, 323 N.C. 238, 245,

372 S.E.2d 692, 696 (1988). "What constitutes a fair return on common equity is a conclusion of law that must be predicted on adequate factual findings." *State ex rel. Utils. Comm'n v. Carolina Util. Customers Ass'n*, 348 N.C. 452, 461, 500 S.E.2d 693, 700 (1998). In the recent decision by the N.C. Supreme Court remanding the 2011 Duke Energy rate case, Docket E-7, Sub 989, to the Commission for sufficient findings of fact on the ROE, the court emphasized the Commission's mandate to consider the "impact of changing economic conditions on customers." *State ex rel. Utils. Comm'n v. Cooper,* ___ N.C. ___, 739 S.E.2d 541 (April 12, 2013).

NC WARN's position is that any of the significant components that make up the rates require the same scrutiny and detailed findings, all are fundamental parts of the rates and bear an influence on the Commission's decision about ROE. In the recent decision by the Supreme Court, the court required the Commission "to make an independent determination regarding the ROE based upon appropriate findings of fact that weigh all the available evidence." *Id.* In its discussion in that case, the court found fault with the Commission's failure to make findings beyond accepting what the court designated as a "nonunanimous" settlement agreement, and required the Commission to conduct a full review of the reasonableness of the ROE, including a weighing of the credibility of witness testimony and other evidence. In the matter *sub judice*, the Commission cannot rely solely on the settlement agreement on such issues as the ROE, and ultimately, the fair and reasonableness of the rates.

Another restriction on the Commission's rate-making authority is the

requirement that rates must reflect the need for the utility service, and this requires an examination of proposed generating facilities and other major expenses the utility proposes to incur. The "present ratepayers may not be required to pay excessive rates for service to provide a return on property which will not be needed in providing utility service within the reasonable future." *State ex rel. N.C. Utilities Commission v. General Tel. Co. of Southeast*, 281 N.C. 318, 189 S.E.2d 705 (1972). The relevant corollary to this is that present ratepayers should not pay excessive rates for service they do not need or will not receive.

As demonstrated below, these restrictions are crucial to assessing the impacts of Duke Energy's proposed rates on residential and small business customers, who would bear the burden of the proposed rates.

PROPOSED FINDINGS

Proposed Finding 1. Duke Energy is not complying with state policy requiring it to provide affordable and economic service to its customers.

In light of the proposed findings below and fully supported by testimony and evidence in the record, the Commission can and should make a finding that Duke Energy is not providing affordable and economic service to its customers, contrary to the public interest. The company does not meet the fundamental requirements for a regulated monopoly within this state.

Duke Energy officials verified under oath that the costs in its application are true and accurate. Tr. Vol. 1, p. 98. At the same time the application is loaded up with costs it knew would be adjusted downwards by the Public Staff through

negotiation in order to reach a level still satisfactory to Duke Energy. Acknowledging a series of "mistakes" does not rectify sloppy accounting procedures that pass on inappropriate costs to customers. Allocating costs for all operations on one hour in the summer is simply unrealistic and it unfairly places the burdens of new plants on residential and small business customers. Manifestly discriminatory practices between customer classes are prohibited, yet they continue.

Finally, in these economic times with unemployment high and interest rates low, it is unconscionable for Duke Energy to raise consumer rates three times in four years and yet request an 11.8% rate hike based on an 11.25% ROE, i.e., profits the company can make on its operations. The present way of conducting business has failed many of Duke Energy's customers; approximately 9% of residential customers, or 140,000 families, are disconnected each year. NC WARN Newton Cross Exhibit 1 (showing 1.6 million residential customers); NC WARN Yarborough Cross Exhibit 1. The rate hike requested by Duke Energy, even as it is reduced by adjustments by the Public Staff and NC WARN witness, Mr. Marcus, would only compound these problems to those most in need.

Most of the hundreds of public witness opposed the rate hike, giving personal testimony on how the rate hike would adversely affect them and their families. NC WARN witness, Mr. Dickerson, State Director of AARP-NC summarized the testimony at the public hearings:

> Seniors have been showing up at the public hearings because they cannot afford annual utility rate increases that threaten their health

> and economic security. Seniors, most on limited incomes, are facing considerable challenges in the current financial times. Many other consumers are facing similar challenges, and are economizing however they are able.

Duke Energy should be looking at ways to make electricity economical and affordable to everyone, not increasing rates every year or two.

> **<u>Proposed Finding 2.</u> The settlement agreement entered into by Duke Energy and the Public Staff does not resolve all of the potential issues and does not provide an adequate basis for determining fair and reasonable rates.**

Currently, Duke Energy's total annual retail sales in NC are approximately $4.66 billion. Revised Fernald Exhibit 1, Schedule 1-1. In the present rate case, Duke Energy initially applied for a rate increase of 9.7% in retail revenues, or approximately $446 million. The filing was based on an 11.25% ROE with the long-term debt to equity ratio set at 47% debt, 53% equity. Application, p. 4. Based on the revenue requirements in the application, the rates of the various customer classes would increase from 5.3% for industrial customers, 9.6% for general service customers, 5.4% for outdoor lighting and 11.8% for Residential customers. *Id.*, p. 12.

A settlement agreement entered into by Duke Energy and the Public Staff was filed on June 17, 2013.[1] In addition to other stipulations and adjustments, the settlement agreement called for an overall 4.5% increase for the first two years, or $205 million annually, based on a 10.2% ROE. Settlement Agreement,

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[1] NC WARN for one was not provided an opportunity to participate in the settlement as it was informed by members of the Public Staff just a few days prior to when the settlement was announced that the Public Staff was fully litigating the case rather than settling.

2.A. After the first two years, the overall rate increase would rise to 5.1%. *Id.*, 8(B) and (I). No customer class would have their rates increased by more than two (2) percentage points over the overall increase. *Id.*, 5(A). The settlement agreement shows that the average residential customer will get a 5.08% increase while the large industrial customers will receive 4.23% and the general service customers will receive 3.42%. *Id.*, Exhibit 3. The basic facility charge ("BFC") (the amount the customer pays each month to be connected to the system, no matter how much electricity is used) will not increase by more than four times the increase assigned to that rate schedule, so for residential customers the BFC will not increase more than 20%. *Id.*, 5(A)(1). Duke Energy further agreed that it would not come in for a rate increase with an effective date prior to two years from the effective date of the present rate request. *Id.*, 8(N). In the settlement agreement, Duke Energy also agreed to make a one-time contribution of $10 million from shareholder funds to agencies that provide energy assistance to low-income customers. *Id.*, 1(D)(5). The settlement agreement specifically does not resolve all of the issues identified in the rate case; the primary area of disagreement between Duke Energy and the Public Staff continues to be the allocation methodologies (discussed in Proposed Finding 3 below).

In all, Duke Energy settled for a $221 million reduction from the original application but was satisfied with the result. Exhibit 1 to the settlement agreement lists the various adjustments and compromises made by Duke Energy and the Public Staff to reach a settlement. The largest of these is a $112 million adjustment made by lowering of the ROE by 1.05%, from 11.25% to 10.2%.

Duke Energy capitulated to the Public Staff adjustments on several other questionable costs (such as lobbying, donations, pensions, aviation expenses), accounting assumptions and regulatory charges, including $30 million reduction in costs for nuclear decommissioning. Lastly, Duke Energy agreed with the Public Staff adjustments to increase several line items from the original application, and by almost $49 million for "other post test year expenses," inflation and increases in salaries.

Duke Energy's application contains a significant number of inappropriate and improper charges, many of which were the same items removed in adjustments to their revenue requirements in the 2009 and 2011 rate cases. See Exhibit 1 to Settlement Agreements in Docket E-7, Sub 909, and E-7, Sub 989. In those applications, the proposed charges challenged by the Public Staff and other intervenors consisted of major line items for hundreds of millions of dollars, such as the ROE, and clearly improper lobbying costs, aviation expenses, costs from other Duke Energy jurisdictions and the vegetation management program. In the 2009 rate case, the ROE requested in Duke Energy's application was 12.3% and it settled for 10.75%, and the original revenue increase requested was $496 million. NC WARN Newton Cross Exhibit 2. In the 2011 rate case, the ROE requested in the application was 11.5% and Duke Energy settled for 10.5%. *Id.* Additionally, the Public Staff determined that millions of dollars in cost recovery sought by Duke Energy were inappropriate and recommended adjustments to line items or removing all the costs from an item.

It is apparent that Duke Energy in the present rate case, as it did in these last two rate cases, has applied for a level of cost recovery considerably higher than what it was willing to accept. Exhibit 1 to the settlement agreement shows the Public Staff's adjustments to Duke Energy's initial request, reflecting most notable reductions and adjustments in the ROE, the equity ratio, storm costs, vegetation clean up, merger-related costs, nuclear decommissioning expenses and other line items similar to those in the 2009 and 2011 rate hikes. See also Revised Fernald Exhibit 1. The question remains, is Duke Energy simply manipulating the process by coming in with exorbitant costs, expecting its request to be reduced in negotiations?

By limiting the Public Staff testimony to the stipulations in the settlement agreement, it is almost impossible to determine the best professional judgment of the Public Staff on what it considered to be proper revenue requirements, yielding fair and reasonable rates.[2] However, one of the integral compromises in the settlement agreement in the rate request was regarding the ROE, and it is one of the few items in the record showing the initial positions of both Duke Energy and the Public Staff.

The negotiated ROE from 11.25 to 10.2% reduced Duke Energy's revenue requirements by $112 million, so it is important to assess the recommendations made by the Public Staff and Duke Energy witnesses. Based on his conclusion from recent securities market data, the Public Staff witness, Dr. Johnson, recommended an ROE between 7.84 - 9.07%, describing it as "the investor

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[2] In a bench ruling, the Chairman prevented cross-examination of the positions developed by the Public Staff, declaring them to be part of settlement negotiation. Tr. Vol. 8, p. 53.

return requirement for the Company's North Carolina operations." Johnson Testimony, pp. 8-9. He based this "from an analysis of historical market total returns, a Discounted Cash Flow (DCF) analysis for a group of 36 public traded comparable electric utilities, and a Capital Asset Pricing Model (CAPM) analysis" with the most weight given to the DCF. Dr. Johnson also looked at comparable earnings of unregulated firms, showing Duke Energy cost of equity in the range of 9.75 - 10.75%. Duke Energy's witness on ROE, Mr. Hevert, recommended an ROE in the range of 10.5 – 11.5%, based primarily on what he characterized as a Constant Growth Discounted Cash Flow model, with a secondary review of a Capital Asset Pricing Model. He then used a series of filters to establish a list of comparable utilities. Tr. Vol. 1, pp. 150-151. Under strenuous cross-examination by the Attorney General and the Commercial Group, Mr. Hevert admitted his ROE recommendations were generally not accepted by other jurisdictions and his recommended ROE was significantly and consistently higher than the ROEs the respective commissions set. Tr. Vol. 1, pp. 166-168.

In the settlement agreement, Duke Energy and the Public Staff negotiated an ROE at 10.2%, approximately half way between the top end of the range, recommended by Dr. Johnson and the bottom end of the range by Mr. Hevert. Dr. Johnson summarized the agreed upon ROE as "in the middle range of dispute." Johnson Testimony, p. 5. Apparently, the other primary rationale for the 10.2% ROE agreed to by Duke Energy and the Public Staff in the settlement agreement is that the Commission had granted both Duke Energy Progress and Dominion Power that amount in their last rate cases. See Orders in NCUC

Dockets E-2, Sub 1023, and E-22, Sub 479. Dr. Johnson stated that he didn't "think it's coincidental that it's the exact same number." Tr. Vol. 3 p. 158.

As noted above in the section on scope of review, an acceptance of the terms of the "nonunanimous" settlement agreement as a rationale for setting the rates does not meet the Commission's mandate in finding that ultimately the rates are fair and reasonable. Neither does blind adherence to ROE's granted to the other utilities within the Commission's purview. Negotiated rates between parties that simply reach the "middle of the range of dispute" do not alleviate the Commission's responsibility to determine the weight and sufficiency of all of the testimony and evidence. Duke Energy witness, Mr. Hevert, stated he was familiar with the recent Maui Electric case before the Hawaii utilities Commission in which the Commission reduced a stipulated 10% ROE to 9%. Tr. Vol. 2, p. 160. The Commission has the authority to do the same in this rate case.

In addition to the agreed upon adjustments, the Public Staff made significant concessions to reach the settlement, most notably a "sweetener" of $47 million, consisting of $22.5 million designated as "post test year expenses," plus increases of $8.4 million in inflation and $18 million in salaries and voluntary severance plan ("VSP"). In his testimony, Duke Energy witness, Mr. Newton, discussed the negotiations with the Public Staff about what the line for post test year expenses should reflect, and stated that "in Duke's view, it reflects a reduction in what we think, if we had litigated this case, the actual test year expenses ... would have been higher in our litigating case than what we have agreed to here." Tr. Vol. 1, pp. 110-111. Without the additional post test year

expenses, there would not have been a settlement, but neither Duke Energy or the Public Staff has provided a clear statement on the basis for the expenses, nor have they justified those expenses in the record.

There are several key problems with the settlement agreement which have prevented the development of a complete record. The settlement agreement was entered into prior to the filing of intervenor direct testimony so does not address substantive issues raised by the intervenors. Further, by settling prior to the completion of the public hearings, the settlement agreement does not reflect concerns of the public. NC WARN witness, Mr. Dickerson, State Director of AARP-NC, expressed his concerns with an early settlement, stating "by settling before the hearings in June and July, the Public Staff and DEC are signaling that public concerns mean very little." Dickerson testimony, p. 2.

Although the rate increase in the settlement agreement was significantly reduced from the original request, many members of the public testified that the rate increase was still excessive, given the state of the North Carolina economy and their personal financial difficulties. The proposed rate increase would have an inordinate impact on low-income and working families and those, such as seniors, on fixed incomes. The economic difficulties facing not only low-income households in general, but the aging and the working poor in particular, make it important to provide Duke Energy's residential customers the ability to maximize their control over their home energy bills. This was expressed succinctly at the various public hearings by the various witnesses.

Each of the major components of the rates, and in particular, the cost

allocation methodology, ROE and the debt-equity ratio, and the appropriateness of Duke Energy's proposed costs should be fully justified. In this case, the fairness and reasonableness of the undesignated post test year "sweetener" expenses should also be closely scrutinized and removed from the rate increase.

<u>Proposed Finding 3</u>. The Summer Coincident Peak ("SCP" or 1CP) methodology proposed by Duke Energy for allocating costs between customer classes fails to result in fair and reasonable rates.

Utilizing different methodologies in allocating costs between customer classes is not just a hypothetical exercise, it has significant real world effects. Duke Energy's preferred methodology, the Summer Coincident Peak ("SCP") allocates costs on the one hour of the year with the highest demand on the system. This causes residential and small business classes to pick up a disproportionate financial burden especially when new plants are needed, and in particular, when expensive new baseload plants are needed.

The settlement agreement expressly delineates the allocation methodologies advanced by Duke Energy and the Public Staff, stating "Duke Energy Carolina has based its filing in this Docket on the Summer Coincident Peak ("SCP") methodology for cost allocation among jurisdictions and among customer classes. The Public Staff advocates the use of the Summer-Winter Peak and Average ("SWPA") methodology for those purposes." Settlement Agreement, 4. The SCP method, also referred to as the 1CP, or one coincident peak, proposed by Duke Energy allocates all costs based on the demand by the various rate classes during the summer peak. The amount of generation is

calculated based on meeting the system coincident peak load with a reserve margin adequate to cover periods of system stress caused by generating plant outages.

In his testimony on behalf of the Public Staff, Mr. Floyd discussed the differences between the two methods and the merits, as advanced by the Public Staff, in the SWPA, stating "the basic fundamental difference is that a portion of those fixed production plant costs are not just assigned on the coincident peak, but a portion of that is assigned also on the energy basis." Tr. Vol. 8, p. 165. The SWPA methodology recognizes the plant-related costs based on summer and winter peaks, and assigns a significant portion to those periods, but also assigns another portion of these same costs to reflect customers' actual usage of the system. In contrasting the single hour relied upon in the SCP methodology, Mr. Floyd stated "each hour dictates what type of resources the system operator is going to use." *Id.*, p. 166.

On behalf of NC WARN, Mr. Marcus also addressed the rate allocation measure requested by Duke Energy and described alternative rate measures that are fairer and more reasonable, and which more rationally reflect both the demand for electricity and energy needs. Tr. Vol. 4, pp. 182-185. Mr. Marcus testified that the allocation of generation costs on the SCP method allocates all costs based on the demand by the various rate classes during the summer peak hour. The amount of generation is generally calculated based on meeting the system coincident peak load with a reserve margin adequate to cover periods of system stress caused by generating plant outages. The SCP method is rarely

used because it does not reflect utility planning, actual use and system stress, nor does it result in rates that are fair and reasonable. Marcus Testimony, pp. 44-58.

However, the type of generation and when it is dispatched by the utility is based on energy considerations. As pointed out by Duke Energy in the conclusions to its Integrated Resource Plan ("IRP"), September 1, 2012, at page 89, the results of the IRP analysis "suggest that a combination of additional base load, intermediate and peaking generation, renewable resources, EE, and DSM programs is required over the next twenty years to meet customer demand reliably and cost-effectively." NCUC Docket E-100, Sub 137. Mr. Marcus testified that Duke Energy witness, Mr. Stillman, in his direct testimony maintained that the purpose of its IRP process is solely to meet its peak requirements plus a reserve margin. Marcus Testimony, p. 47. Mr. Stillman took exception with this and stated

> the Company has been and continues to be a summer peaking utility, and thus the projected summer peak demand drives the time need for adding new resources. Peaking units are not necessarily the best resource to meet the capacity need, as the most economic resources addition is dependent on the existing resource mix, fuel prices, cost of resource technologies, load and energy projections, site availabilities, and various other factors

Stillman Rebuttal Testimony pp. 11-12. However, this longer explanation supports Mr. Marcus's position on how utilities actually plan for and construct generation; meeting demand throughout the year is not based simply on what meets the one hour peak demand. As Mr. Floyd maintained, Duke Energy is not building the Cliffside coal plant and the Dan River natural gas plant for peaking

purposes. Tr. Vol. 8, p. 167.

The problem with the SCP methodology is that it allocates all of the costs based on demand during one coincident peak and discounts all of the other factors, except for peaking requirements. Nuclear and coal plants, and frequently more often, large combined-cycle natural gas plants, are not built to meet short-duration peak loads. Duke Energy witness Mr. Jamil agreed that no one would ever build a nuclear plant for peaking purposes. Tr. Vol. 1, p. 258. If the load were of short duration, a baseload plant would not be a reasonable choice, and the utility would choose to build a peaking plant such as a combustion turbine. In fact, the plants Duke Energy is seeking recovery in the rate case, Cliffside Unit 6, a 825-MW coal plant, and the Dan River combined cycle, a 625-MW natural gas plant, are both considered baseload plants by the company and will be used as such. Neither are peaking units although their costs are allocated under the SCP methodology based on the peak summer hour.

The single peak SCP method also is prone to manipulation; the utility can inform some of its larger customers that a peak event is likely to happen, so that they can partially self-interrupt for a short period of time and greatly reduce the allocation of peak demand for their customer class for the entire year. Although Duke Energy witnesses maintained the utility did not notify customers of the specific summer peak since that cannot be known in advance, Duke Energy does have programs in which large customers, on time-of-use rates, are notified of potential peak periods. Mr. Floyd testified that Duke Energy has programs to notify some large high-load industrial customers about peak periods and that

they and other time-of-use customers have price signals to reduce during peak periods. Tr. Vol. 8, pp. 169-170. Duke Energy witness, Mr. Bailey also described peak reduction programs available to large customers, including the HP rate providing hourly signals. Tr. Vol. 6, p. 61. Direct notice and price signals are just not available for residential customers. The effect of this is that the high load customers are more likely than residential and small business customers to curtail their demand during peak periods.

Mr. Marcus described several allocation methods taking energy into consideration and recommended the peak credit method, where the costs of a combustion turbine are treated as demand-related and excess costs above the combustion turbine costs are energy-related. Marcus Testimony, pp. 59-75. Mr. Marcus further testified that as a matter of general principle, the peak credit method is one of several ways that regulators recognize in which relatively inexpensive peaking plants are built to meet peak loads, but relatively expensive baseload facilities are constructed instead of cheaper peaking plants to meet sustained energy loads. Even assigning combustion turbine fuel as demand-related, Mr. Marcus assigned 54.5% of the cost of Duke Energy generation plant and O&M as energy-related and the remaining 45.5% as demand-related.

In his testimony, Mr. Marcus also provided information showing that a number of other state commissions use either a peak credit or average and peak demand method (similar to the Summer-Winter Peak and Average or SWPA method recommended by Public Staff in previous cases) for classifying

generation plant costs between demand and energy. The states using a form of peak credit include Arkansas, Minnesota, Wisconsin, states in the Pacific Northwest, Nevada, and California. Marcus Testimony, pp. 59-60.

To yield fair and reasonable rates that do not discriminate between customer classes, rate allocation should reflect the different types of generation throughout the entire year. Under SCP, high load factor industrial customers would pay far less for a new capital-intensive baseload unit than for a peaking plant even if the costs were equivalent, while residential and small business customers would pay far more. The use of a peak demand-related allocation methodology in fact may encourage high load customers to promote costly new plants over less costly alternatives based solely on fuel costs.

The demand placed on Duke Energy's system from the high load data centers highlights the problem – they demand 24-7 power throughout the year yet only have costs allocated on the one hour peak.[3] Duke Energy's only response to the value of the new high load data centers to the other rate payers is that they help pay the fixed costs of the system. Duke Energy witness Mr. Newton stated "I would say customers that they are better off with data farms on the system, that those data farms are paying for some of the fixed costs of our system." Tr. Vol. 1, pp. 211-212. This is an extremely thin benefit since many of the components of fixed costs are depreciating, and present customers have been paying for them since they became used and useful. As noted in Proposed Finding 5 below, the transmission/distribution system, a fixed cost, is

[3] Duke Energy witness Mr. Baily testified that the OPT-G rate is 6.2209¢/kwh on-peak and 3.4604¢/kwh off-peak; the OPT-H rate for the data centers is similar. Tr. Vol. 6, p. 61.

overwhelmingly allocated to residential customers. In a discussion on data centers, Duke Energy witness Mr. Stillman testified that a shift to an allocation methodology that considered energy in addition to the demand at peak periods would shift "some more fixed production cost to those high load customers." Tr. Vol. 4, pp. 72-73. Lastly, the new high load customers with their 24-7 year-round demand are the drivers for new baseload plants, and if a new generating plant is built to meet that demand, fixed costs for the company would increase by a large margin, therefore reversing Duke's claims that adding data centers helps other customers.

As noted by the recent Supreme Court decision in the 2011 Duke Energy rate case, the Commission is required to directly address the testimony of both Mr. Floyd and Mr. Marcus that the rates determined by the SCP methodology are not fair or reasonable. *Cooper, supra.* What is also important is that the end result of the SCP methodology is often discriminatory between customer classes, and therefore impermissible. *N.C. Textile Mfrs, supra.* The use of the SCP leads to residential and small business classes picking up a higher share of the financial burdens for new baseload power plant construction, such as the Cliffside and Dan River plants, while the high load customers who require that power throughout the year pay only the percentage they use during the single summer peak hour.

Although the Commission acquiesced to the SCP by approving the Settlement Agreement in both the 2011 Duke Energy rate case, and the 2012 Duke Energy Progress rate case, it has not uniformly approved it for all rate

cases. For example, in its recent Order Granting General Rate Increase, Docket E-22, Sub 479, December 21, 2012, the Commission found that the "Summer/Winter Peak and Average (SWPA) methodology is the appropriate methodology for determining the [Dominion Power's] North Carolina jurisdictional and retail customer class cost allocation and responsibility." Order, Finding 5. Additionally, in its 1988 rate case, Carolina Power & Light (now Duke Energy Progress) and its industrial customers asked the Commission to switch to a single peak-only method, but the Commission refused, stating "without baseload plants, CP&L would simply not be able to serve its high load factor customers. It is only appropriate that high load factor customers pay their share of the cost of the base load plants built primarily to serve them." Docket E-2 Sub 537, Order Granting Partial Increase in Rates and Charges, p. 130. The reasoning behind the 1988 ruling holds today – allocation of costs should focus on both demand and the use of energy, because without a consideration of both, high load factor customers do not pay their fair share.

NC WARN's position is that between the two methodologies proposed by Duke Energy and the Public Staff, the SWPA methodology more fairly allocates costs, because it considers both the energy component as well as peak demand. As a justifiable alternative to the SWPA, the peak credit method propounded by Mr. Marcus would result in rates that were fairer and more reasonable, as it requires a fuller review of the need for baseload, intermediate and peak generating facilities throughout each day for the entire year to meet the needs of all customers in all of the customer classes.

<u>Proposed Finding 4</u>. Duke Energy's proposed revenue requirements included significant numbers of inappropriate and improper charges that should be summarily removed.

Duke Energy's application, similar to its applications in the 2009 and 2011 rate cases discussed in Proposed Finding 2 above, contains a significant number of inappropriate and improper charges that would result in excessive recovery. Both the Public Staff and NC WARN pointed out the improper costs they discovered through their review of Duke Energy's accounts. NC WARN agrees with most of what the Public Staff made in adjustments, although questions the ROE compromise, the inclusion of the post test year "sweeteners" and the failure to include all merger-related costs and savings.

As evidenced by Exhibit 1 to the Settlement Agreement, the Public Staff clearly disagreed with the appropriateness of many of the line items in the initial rate hike application. After negotiation, Duke Energy's revenue requirements were reduced by a net approximately $189 million, taking into consideration the "sweeteners" for post test year expenses, inflation and salaries described above that were added back in order to achieve settlement. Duke Energy agreed to significant reductions from its original application, including:

a. the debt cost rate was reduced from 5.29% to 5.23%, an adjustment of $1.7 million in line 6;

b. as discussed above, the ROE was reduced from 11.25% to 10.2%, an adjustment of $112 million, in line 7;

c. Progress merger related expenses were reduced by $2.3 million in line 18 and Cinergy non-recoverable costs to achieve from that merger were reduced

by $2.7 million in line 17;

d. storm costs were reduced by $15.6 million in line 20;

e. vegetation management was reduced by $6 million;

f. nuclear decommissioning expenses were reduced by $19.7 million in line 28;

g. aviation expenses were reduced by $1.2 million in line 29;

h. donations and sponsorships of $600,000 were removed in line 30;

i. lobbying costs of $1.3 million were removed in line 31.

Each of these items is more fully described in Revised Fernald Exhibit 1, showing Duke Energy's exaggerated costs in its application.

The other major flaws in the application are its failure to pass through to the ratepayers the post test year merger savings and significant merger-related expenses. This is reflected in the Duke Energy Corporation 2012 Annual Report, page 8, regarding merger efficiencies, in which Mr. Rogers, CEO of Duke Energy, states "we're also on track to achieve approximately 5 to 7 percent savings in non-fuel operating and maintenance." NC WARN Newton Cross Exhibit 4. None of these substantial savings are reflected in the revenue requirements Duke Energy maintains is appropriate for the test year, even though 5 - 7% of Duke Energy Carolina's $2 billion non-fuel O&M, in the $100 - 140 million range, is not an insignificant amount. These merger-related savings occur in functional consolidation (50%) through eliminating employees in the two merged companies, employee severance and real estate rationalization; systems consolidation (20%) through consolidating the IT systems of the two companies;

operational management best practices (20%) in combining staff teams and departments; and supply chain (10%) harmonization between the merged companies. NC WARN Newton Cross Exhibit 3.

Duke Energy witness, Ms. Shrum, testified that the costs of the voluntary severance program had already occurred even though most occurred after the end of the June 30, 2012 test year.[4] Tr. Vol. 6, pp. 178-179. Ms. Shrum also admitted there were costs in consolidating the IT systems of the merged companies, although she stated the consolidation would lead to future savings. Tr. Vol. 6, pp. 175-176. Summing up these costs, Ms. Shrum stated "I would characterize them as cost to achieve merger related savings, and they are in the Application." Tr. Vol. 7, p. 109. These are clearly merger-related costs and should not be passed on to ratepayers. Any savings incurred through reducing staff, consolidating IT systems and other savings from the merger will occur after the test year and would benefit Duke Energy's shareholders rather than the ratepayers.

In his testimony on behalf of NC WARN, Mr. Marcus addressed several of the same line items as did the Public Staff, but also established additional improper revenue requirements he discovered in his analysis totaling in excess of $30,002,000 (at the Duke Energy level before allocation to North Carolina). In his review of a limited number of FERC accounts, Mr. Marcus identified numerous mistakes and misallocations, almost 5% of the total he reviewed, and

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4 As part of the Settlement Agreement, Duke Energy agreed to extend certain of the revenue requirements to March 31, 2013, in order to pick up some of the merger-related savings, such as the VSP participants.

he additionally noted hundreds of undocumented charges, primarily meals, all of which Duke Energy proposed to pass on to ratepayers. His recommendations included the following adjustments:

a. $24,889,000 for stock-based compensation to executives, the value of which is based solely on Duke Energy's stock price. This compensation does not align the interests of shareholders and ratepayers, is not known and measurable, and encourages executives and directors to agree to charge ratepayers for executive pay, which could never happen in a competitive industry. See NC WARN Shrum/Wiles Cross Exhibit 2, discussed by Ms. Shrum, Tr. Vol. 7, pp. 101-104; Marcus Testimony, pp. 28-36, Tr. Vol. 4, pp. 188-190.

b. $2,035,000 for image and other advertising that ratepayers should not pay for. Marcus Testimony, pp. 14-16; Marcus Exhibit 3.

c. $1,402,000 of the post-merger costs to assign 50% of directors and officer's liability insurance to shareholders because shareholders (as opposed to ratepayers) are often beneficiaries of the proceeds of these policies. Marcus Testimony, pp. 39-42; NC WARN Shrum/Wiles Cross Exhibit 1.

d. $1,361,000 of dues and donations to the Nuclear Energy Institute, $633,000 for the Edison electric institute, and $188,000 of chamber of commerce dues based on these organizations' strong advocacy for political positions and spending on public relations and advertising. Marcus Testimony, pp. 16-24.

e. $621,000 for improper political and charitable contributions and sponsorships. Marcus Testimony, p. 24-25.

f. $275,000 for excess survey research expenditures in the test year that

are non-recurring or duplicative. Marcus Direct Testimony, pp. 25-28.

g. $549,593 in disallowances in accounts 908, 910, 910.0 and 912 merger-related charges, including $156,753 for the Zapata Engineering study of the Crystal River nuclear plant in Florida. Mr. Marcus Supplemental Exhibit 1.

In addition to making some concessions to inappropriate political contributions and the Zapata Engineering merger-related expenses, Duke Energy's response to Mr. Marcus's analysis was to propose a self-audit of the method it handles its cost recovery with an agreement to submit the results of the audit to the Commission. Although NC WARN believes this is a necessary step to preclude similar misallocations in the future, it does not provide an excuse for presenting the same exaggerated costs in the last three rate cases. NC WARN maintains that the magnitude of the mistakes and overblown requests made in Duke Energy's application rise to the level of severity requiring a penalty. Because of the initial overreaching in the application and number of misallocations he noted in his analysis, Mr. Marcus recommended a penalty of 5 basis points in ROE in his direct testimony, but given the continuing problems found in late-filed responses to data requests, he recommend the penalty to be increased by 10 basis points. Tr. Vol. 4, pp. 181-182.

As expressed by several of Duke Energy's witnesses and summed up by Duke Energy witness, Mr. Newton, in response to Mr. Marcus's recommended adjustment, "however, the issue has become moot since the settlement removes far more than $4 million from our initial revenue request." Tr. Vol. 1, p. 95. This was echoed by Duke Energy witness, Ms. Shrum, "the remaining portion of [Mr.

Marcus's] $5 million in adjustments is essentially moot because they are far eclipsed by the Company's concessions of approximately $200 million in the context of the settlement." Tr. Vol. 6, p. 148. In his testimony, Mr. Wiles reiterated the company's position,

> the Company's accounting policies and practices do not always prevent all accounting errors, but through the rate making and auditing process of the Company's approximately $5 billion total revenue requirement, the potential impact to customers of the issues raised by witness Marcus have been remedied in the Settlement.

Tr. Vol. 6, p. 145. This attitude is troublesome. Concessions in a settlement agreement do not somehow whitewash a long list of mistakes, nor does it address the manipulation of the process.

Proposed Finding 5. The classification of costs proposed by Duke Energy is discriminatory to residential customers.

Even beyond the patently unfair SCP cost allocation methodology, residential customers are unfairly allocated a significant portion of the utility's demand-related costs. In his testimony, Mr. Marcus provided fairer alternatives to Duke Energy's cost of service study by using the peak credit method for cost allocation and then made adjustments to the cost-of-service study in two significant areas: the minimum system allocation of distribution costs and the allocation of account representatives. Marcus Testimony, Table 17, p. 95.

In his testimony, Mr. Marcus expressed his disagreement with Duke Energy's minimum system allocation of distribution costs that assigns a significant portion of poles, wires, and transformers as customer-related. Marcus

Testimony, pp. 75-87. Mr. Marcus recommended classifying all costs of distribution poles and wires as demand-related, since the distribution system is largely built to serve customer demand. The basic point is that if there were only a limited demand, the system would not be expanded at utility expense under line extension rules. Other problems with Duke Energy's minimum system are: (1) that the minimum system can carry a significant portion of the small customers' demand but demand is double counted; and (2) other methods of calculating a theoretical customer component to the system suggest that poles and wires' costs vary with their capacity without a fixed component. Duke Energy's methodology has been called into question for fifty years, and has been rejected in a number of states including Texas, Arkansas, Washington, and Illinois.

In a different cost allocation between customer classes, Mr. Marcus recommended that the Commission change the allocation of the cost of major account representatives who serve large non-residential customers. Marcus Testimony, pp. 87-91. The costs of the account representatives are currently allocated 98% to residential and small business customers. It is patently unfair to allocate 98% of the costs of economic development, sales, and marketing expenses as a benefit to all customers when the services provided by Duke Energy in these areas are focused on industrial and large commercial customers.

The use of the peak credit allocation method and the reasonable adjustments to the cost-of-service study reduces costs allocated to the residential class by $149 million, or approximately 6.3% lower than Duke Energy's originally

proposed level of revenue requirements for that customer class. Tr. Vol. 4, p. 187. After a close examination of the ROE, it is evident Duke Energy should not receive a rate increase.

CONCLUSION

In light of the above, and to make the rates just and reasonable, and economical to all ratepayers, the Commission should:

1. deny Duke Energy's application (as negotiated in the settlement agreement) as excessive in the current economic conditions as the proposed rates would adversely affect all customers in all customer classes; and

2. find that Duke Energy has acted against public policy by not providing affordable and economic service to its customers.

OR IN THE ALTERNATIVE

The Commission should take the following actions:

1. approve rates based on the peak credit allocation methodology to protect residential and small business customers from unfair and discriminatory rates;

2. reduce the ROE to 9.0%;

3. reduce the revenue requirements for the stock-based compensation and the other items referenced in the testimony of Mr. Marcus as inappropriate costs to ratepayers;

4. reallocate transmission and distribution lines, and account representatives as outlined in the testimony of Mr. Marcus;

5. further reduce the ROE by 10 basis point as a penalty for inappropriate and misallocated costs;

6. order Duke Energy to conduct a self-audit of the method it handles its cost recovery and submit its report to the Commission and parties;

7. order Duke Energy not to include inappropriate, misallocated or overblown costs in future rate cases;

8. eliminate the post test year expenses of $38,471,000 included as a "sweetener" for the settlement agreement;

9. amend the settlement agreement where necessary; and

10. make all necessary findings and conclusions in order to determine fair and reasonable rates

Respectfully submitted, this the 19th day of August 2013.

FOR NC WARN

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing NC WARN'S BRIEF upon each of the parties of record in this proceeding or their attorneys of record by emailing them an electronic copy or by causing a paper copy of the same to be hand-delivered or deposited in the United States mail, postage prepaid, properly addressed to each.

This the 19th day of August 2013.

John Runkle

Attorney at Law